

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

RECEIVED
JUN 21 2000
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)	
)	
Policy and Rules Concerning the Interstate, Interexchange Marketplace)	CC Docket No. 96-61
)	
Implementation of Section 254(g) of the Communications Act of 1934, as amended)	
)	
1998 Biennial Regulatory Review—Review of Customer Premises Equipment and Enhanced Service Unbundling Rules in the Interexchange, Exchange Access, and Local Exchange Markets)	CC Docket No. <u>98-183</u>

EX PARTE DECLARATION OF
JANUSZ A. ORDOVER AND ROBERT D. WILLIG
ON BEHALF OF
AT&T CORP.

June 21, 2000

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554**

RECEIVED

JUN 21 2000

**FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY**

In the Matter of)	
)	
Policy and Rules Concerning the Interstate, Interexchange Marketplace)	CC Docket No. 96-61
)	
Implementation of Section 254(g) of the Communications Act of 1934, as amended)	
)	
1998 Biennial Regulatory Review—Review of Customer Premises Equipment and Enhanced Service Unbundling Rules in the Interexchange, Exchange Access, and Local Exchange Markets)	CC Docket No. 98-183

**EX PARTE DECLARATION OF
JANUSZ A. ORDOVER AND ROBERT D. WILLIG**

1. Janusz A Ordover and Robert D. Willig hereby declare as follows:

I. DECLARANTS AND THEIR QUALIFICATIONS

A. Janusz A. Ordover

2. I am Professor of Economics and Director of the MA Program at New York University, which I joined in 1973. At New York University, I teach undergraduate and doctoral level courses in industrial organization economics, the field of economics concerned with competition among business firms and upon which “antitrust economics” is founded. I have devoted most of my professional life to the study and teaching of industrial organization economics and to its application through antitrust and regulatory law and policy.

3. In July 1991, President George Bush appointed me to the position of Deputy Assistant Attorney General for Economics in the Antitrust Division of the United States Department of Justice ("DOJ"). In this post, I participated in the drafting of the 1992 Horizontal Merger Guidelines, which have been widely used by courts and antitrust enforcement agencies. In addition, I led many merger reviews that employed and developed methodologies to define relevant markets in merger and other cases. I returned to New York University in 1993.

4. I have been actively involved in the formulation of public policy in the telecommunications sector. In particular, I have submitted written and oral testimony for AT&T to the Federal Communications Commission ("FCC") and to the state regulatory commissions in the Midwest, New England, and New York on a number of issues, including the pricing of unbundled network elements, access to bottleneck facilities, bundling of complementary services by regulated firms, and other vertical competitive issues.

5. I have written extensively on a wide range of antitrust and telecommunications topics, such as mergers and joint ventures, predatory conduct and entry barriers. My antitrust articles have appeared in the *Yale Law Journal*, *Harvard Law Review*, *Columbia Law Review*, and many other journals, monographs and books, here and abroad. A full list of my articles and other professional publications and activities is presented in my *curriculum vitae*, which is attached as Exhibit 1.

6. I have lectured extensively on antitrust topics to the American Bar Association, the International Bar Association, and the Federal Trade Commission ("FTC"). I recently deliv-

ered lectures to the FTC during its hearings on the Future of Antitrust Enforcement, which were organized by FTC Chairman Robert Pitofsky. I have also lectured on antitrust policy at colleges and universities in the United States and abroad, and at many conferences and meetings sponsored by various legal organizations.

7. I have acted as a consultant on antitrust and other competition matters to the DOJ, the FTC, and the post-communist governments of Poland, Russia, and Hungary. I have also consulted for the World Bank and the Organization for Economic Cooperation and Development in Paris. I have acted as a consultant in numerous antitrust lawsuits and investigations, including market definition and anti-competitive conduct matters for the FTC, DOJ and private clients in the United States, Australia, Germany, New Zealand, South Africa and the European Union. I have extensive experience in the analysis of competitive effects of business strategies, including tying and bundling.

B. Robert D. Willig

8. I am Professor of Economics and Public Affairs at the Woodrow Wilson School and the Economics Department of Princeton University, a position I have held since 1978. Before that, I was Supervisor in the Economics Research Department of Bell Laboratories. My teaching and research have specialized in the fields of industrial organization, government-business relations and welfare theory.

9. I served as Deputy Assistant Attorney General for Economics in the Antitrust Division of the DOJ from 1989 to 1991. I also served on the Defense Science Board task force

on the antitrust aspects of defense industry consolidation and on the Governor of New Jersey's task force on the market pricing of electricity.

10. I am the author of *Welfare Analysis of Policies Affecting Prices and Products*, *Contestable Markets and the Theory of Industry Structure* (with W. Baumol and J. Panzar), and numerous articles, including "Merger Analysis, IO theory, and Merger Guidelines." I am also a co-editor of *The Handbook of Industrial Organization*, and have served on the editorial boards of the *American Economic Review*, the *Journal of Industrial Economics* and the MIT Press Series on regulation. I am an elected Fellow of the Econometric Society and an associate of The Center for International Studies.

11. I have been active in both theoretical and applied analysis of telecommunications issues. Since leaving Bell Laboratories, I have been a consultant to AT&T, Bell Atlantic, Telstra and New Zealand Telecom, and have testified before the U.S. Congress, the FCC, and the public utility commissions of about a dozen states. I have been on government and privately supported missions involving telecommunications throughout South America, Canada, Europe, and Asia. I have written and testified on such subjects within telecommunications as the scope of competition, end-user service pricing and costing, unbundled access arrangements and pricing, the design of regulation and methodologies for assessing what activities should be subject to regulation, directory services, bypass arrangements, and network externalities and universal service. On other issues, I have worked as a consultant with the FTC, the Organization for Economic Cooperation and Development, the Inter-American Development Bank, the World Bank

and various private clients. A full list of my articles and other professional publications and activities is presented in my *curriculum vitae*, which is attached as Exhibit 2.

II. PURPOSE AND SUMMARY OF DECLARATION

12. We have been asked by AT&T Corp. to comment on certain issues raised by the FCC's proposal to eliminate the restrictions on bundling of basic telecommunications services with customer premises equipment ("CPE") or with enhanced services. *See* Further Notice of Proposed Rulemaking, FCC 98-258, released October 9, 1998, in CC Docket Nos. 96-61 and 98-183.¹ As we explain below, the decision whether to allow bundling of these services should

¹ The FCC has defined "basic" telecommunications service as a pure transmission capability over a communications path that is virtually transparent in terms of its interaction with customer supplied information. From the customer's perspective, the transmitted information emerges essentially unchanged by its transmission through the regulated telecommunications network. Examples of such services include long distance and local exchange services, including local access.

"Enhanced" services use computer processing to transform the transmitted information. These computer processing applications (1) act on the format, content, code, protocol or similar aspects of the subscriber's transmitted information; (2) provide the subscriber additional, different, or restructured information; or (3) involve subscriber interaction with stored information. Examples of services classified as "enhanced" by the FCC include voice mail, e-mail, interactive voice response, protocol processing, gateway, and audiotext information services. However, tariffed services such as call forwarding and speed dialing are considered "adjuncts" to basic service rather than enhanced services, because they do not alter the fundamental character of the basic service.

Customer premises equipment ("CPE") is terminal equipment located at a subscriber's premises and which is connected with the termination of a carrier's communication channel(s) at the network interface at that subscriber's premises.

focus on the market power of the seller and the overall competitive conditions in the relevant markets.

13. Bundling entails the offer of two or more goods or services at a single price, typically less than the sum of the separate prices.² In a wide variety of market situations, bundling offers many competitive benefits to buyers and sellers alike. For purchasers, an important benefit is “one-stop shopping”—the ability to buy multiple goods and services in a single transaction with a single vendor. It also might lower the costs of paying bills for one’s purchase. One-stop shopping reduces purchasers’ costs of searching for and purchasing the desired goods and services.

14. The economic benefits of bundling go beyond one-stop shopping, however. For sellers, bundling might reduce the costs of billing and otherwise transacting with buyers. The ability to bundle also gives sellers incentives to ensure that complementary goods and services work well together; that suppliers of complementary goods spend enough money on joint marketing and sales; and that purchasers can turn to a single entity for diagnosing and servicing any defects in the bundle after the sale is completed. Finally, and critical to our analysis, bundling can foster the dissemination of efficient complements, and facilitate an effective recovery of R&D costs and other fixed costs.

² The terms “one-stop shopping” and “bundling” are sometimes used interchangeably. In this declaration, however, we use the former term for a single transaction involving separately priced goods, and the latter term for the offer of a bundle of goods.

15. Experience and economic theory teach that unfettered opportunity to bundle in competitive markets unambiguously enhances consumer welfare. Consumers in such markets are free to choose among firms offering competing bundles, or to buy the components on a stand-alone basis. If consumers do not value bundles, market participants will have every incentive to offer unbundled components on a stand-alone basis. Moreover, in competitive markets, bundling is unlikely to impede entry into the provision of competing bundles or bundle components. Irrespective of the actual structure of the market, firms that lack market power should be allowed to bundle their offerings because these offerings cannot distort competition or harm consumers. Firms without market power must deliver what purchasers want, or be placed at a competitive disadvantage. There are no competitive costs to offset the significant benefits of permitting bundling by firms lacking market power. Hence, a policy that permits bundling in competitive markets conduces to overall consumer welfare and promotes adoption and diffusion of new products and technologies.

16. In contrast, bundling by a firm with monopoly or dominant market position could engender competitive concerns. These concerns are exacerbated when the bundling vendor is a regulated firm that offers its products in competition with rivals that (a) are nondominant or lack market power; and (b) may have to purchase some of the necessary components of the bundle from the incumbent monopolist. As explained in more detail below, bundling by a regulated dominant firm can harm consumers, can create impediments to entry by new firms, and can be profitable without creating the kinds of benefits bundling may produce in competitive markets. If regulation constrains the firm from fully exploiting its pricing power in its core markets,

bundling can serve as a vehicle for profitably leveraging monopoly power into adjacent markets. For example, the monopolist can use the monopoly service or services to subsidize the bundled competitive services so as to lessen competition; or it can give favored suppliers of the bundled competitive services preferential access to the technical specifications of the dominant firm's network and "share" the profits from such preferential arrangement. These risks are great enough to warrant maintaining existing restrictions on incumbent local exchange carriers ("incumbent LECs"), until these dominant carriers lose their market power over local exchange services and local access. As long as the incumbent LECs retain substantial market power over local services, they have an ability and incentive to use bundling to injure competition in the core market and in ancillary markets for complementary goods or services.³

17. Approval of a local carrier's Section 271 application is not sufficient, without more, to justify relaxing the restriction on bundling by the incumbent LECs. Bell Atlantic's performance in New York since approval of its Section 271 application for that state underscores how easily the incumbent LECs could sabotage competition from rivals that must rely on the incumbent LECs' bottleneck services. Until the FCC and the public have gained practical experience with implementation of section 271, it is premature to conclude that non-facilities based competition—including the right of competing carriers to purchase the UNE platform from

³ Although this potential for anticompetitive abuse exists with respect to incumbent LEC bundling of basic services with enhanced services or CPE, the threat is greater and more evident with respect to enhanced services because they incorporate basic services supplied by entrenched incumbents. This declaration therefore focuses on the threat posed by incumbent LEC bundling of basic services with enhanced services.

the dominant carrier—suffices to protect against potential competitive injury from bundling of basic local service with other services by the incumbent LEC.

III. BUNDLING OF BASIC TELEPHONE SERVICES WITH CPE AND ENHANCED SERVICES OFFERS MAJOR BENEFITS TO CONSUMERS.

18. The public policy decision whether to allow bundling of basic telecommunications services with enhanced services or CPE should focus on the market power of the carrier who wishes to engage in such bundling, and on the overall competitive conditions in the relevant markets for the components of the bundle. Bundling decisions by interexchange carriers, which face effective competition in long distance, enhanced services and CPE, are unambiguously pro-competitive. There are no plausible competitive harms to offset the significant competitive benefits offered by bundling. In contrast, as long as the incumbent LECs retain both their dominance over local exchange and access services and their regulated status, allowing them to bundle those services raises competitive concerns. We discuss the potential competitive benefits of bundling in this section. Section IV demonstrates the absence of offsetting competitive risks from bundling by interexchange carriers. In Section V, we discuss the competitive risks of bundling by the incumbent LECs.

19. Bundling entails selling two or more goods (or services) in a single package. With “pure” bundling, the seller offers the goods *only* in a package. With “mixed” bundling, the seller offers the goods either bundled or unbundled and the price of the bundle is typically set

below the sum of the prices for the unbundled components.⁴ Firms may bundle goods for competitive or for anticompetitive reasons. As regulators, courts, antitrust policy-makers, and scholars have recognized, in some market settings, firms with market power over one good can use bundling to extend that market power into markets for other goods. Bundling is also practiced in markets that are vigorously and robustly competitive. Manufacturers of radios and CD players bundle them with speakers or headphones. PC manufacturers bundle central processing units with disk drives and operating system software. Cereal and detergent manufacturers offer the same products in varying container sizes; the bundle consists of multiple units of the same commodity. Fast food restaurants offer hamburgers with fries and a drink at a package price that is lower than the sum of individual prices.

20. The FCC has recognized the pervasiveness and economic benefits of bundling in competitive markets, noting that “[p]ackaged offerings are commonplace in a variety of industries in which customers can purchase a number of goods in a package at a lower price than the individual goods could be purchased separately.”⁵ And the FCC has properly concluded that bundling can be an “efficient distribution mechanism” and an “efficient promotional

⁴ H.R. Varian, “Price Discrimination,” in 1 R. Schmalensee and R. Willig, *Handbook of Industrial Organization* 626 (1989).

⁵ See *Bundling of Cellular Customer Premises Equipment and Cellular Service*, CC Docket No. 91-34, 7 FCC Rcd. 4028, 4035 n.35 (1992) (“*Cellular Bundling Order*”) (noting also that bundling is legal under the antitrust laws as long as it does not constitute an illegal tie-in or represent an unlawful exercise of monopoly power, citing cases).

mechanism” that can allow consumers to obtain goods and services “more economically than if it were prohibited.”⁶ We believe that this conclusion is well founded.

21. Economists have identified a variety of benefits to consumers that can result from allowing suppliers in competitive markets to engage in one-stop shopping generally and bundling specifically. The benefits of these arrangements fall into two general categories: benefits created by reducing transaction costs, for both buyers and sellers, and improved recovery of fixed and sunk costs under competitive conditions. We first discuss sources of these benefits. Then we offer several examples of how they could arise from bundling of basic telephone services with enhanced services or CPE.

A. Reduction of Transaction Costs

22. Bundling⁷ can eliminate or reduce several kinds of transaction costs incurred by customers and suppliers.⁸ First, bundling can greatly reduce purchasers’ search costs—the cost of time and effort needed to become informed about the products and services available in the market, to negotiate appropriate purchase terms, and to assemble the desired combination of products (or services). This benefit has particular importance when, as is often true of enhanced services and CPE, the bundled products and services are perceived by consumers to be complex.

⁶ FNPRM at ¶ 14 (citing *Cellular Bundling Order*, 7 FCC Rcd. at 4030-31).

⁷ One-stop shopping can also deliver some, but by no means all, of the benefits discussed in this declaration.

⁸ See KMC at 4 (bundling would permit “carriers to offer consumers reduced prices that reflect savings in transaction costs”); GTE at 5.

Second, the ability to bundle gives suppliers incentives to make sure that the complementary goods included in the bundle function properly with each other, and ensures that the vendor will be responsible if they do not function properly. Bundling enables the customer to receive the desired products and services already assembled and working properly, without spending additional time and money assembling, testing and adjusting the components. Moreover, testing systems from the same company are more likely to work better together. In sum, a carrier selling a bundle of service(s), including CPE and/or enhanced services, has the appropriate incentive to ensure that all the components work together well and are fully compatible with the carrier's phone network (especially when sophisticated CPE is involved). On the other hand, a seller who is proscribed from bundling may have lessened incentives to ensure that all complementary components of the package work well together.

23. Bundling can also reduce the purchasers' transaction costs of verifying that the services and goods actually perform as promised by the seller, and of getting the seller to correct the problem when they do not perform as promised. Plainly, a vendor who values its reputation has an incentive to assume responsibility to the purchaser for the performance of the bundle. Without bundling, the buyer faces a greater risk that individual vendors will try to shun the responsibility when the system needs repair or additional setup work to perform as promised. Indeed, this concern is not merely a reflection of the sellers trying to shirk responsibility, but also of the fact that responsibility is often genuinely difficult to allocate.

24. Bundling helps minimize selling and billing costs. Bundling allows the seller to maintain a single inventory entry for the bundle, rather than individual inventory records for each

component in the package. Likewise, the seller can submit a single bill for the entire bundle, rather than a separate charge for each component. The FCC recognized the importance of these benefits in approving the AT&T/TCI merger:

“[A] blanket ban on bundling might well prevent competitively harmless transactions. Post-merger, AT&T-TCI may well have lower costs in billing and servicing customers that subscribe to several of its products. . . . [B]y offering these products as a package at a price below that of the individual prices . . . , the merged firm would offer both lower costs and pass at least some of those costs savings on to consumers.”

TCI Order, Docket 98-178, FCC 99-24 (Feb. 18, 1999).

25. Bundling promotes incentives for sellers to assemble supplies and other complementary goods that work well together. When a durable capital good and other complementary goods are sold separately, purchasers may buy complementary goods of inefficiently low quality, causing the capital good to operate poorly. When the inferior complements make the whole system malfunction, the manufacturer of the core good or service may suffer unwarranted damage to its reputation that may well extend to many potential customers.

26. This issue is most likely to arise when the technology is complex, and quality differences among competing brands of the complementary goods are hard to detect. First, buyers may simply be poorly informed about the specifications of the complementary goods needed for optimum performance. Moreover, when components are sold on a stand-alone basis, sellers may have inadequate incentives to inform consumers about system requirements. This is a “free rider” problem: many of the benefits of educating buyers go to sellers of complementary

or competing goods, even when these sellers contribute nothing to the cost of the education campaign. Second, because some costs of damage to a manufacturer's reputation are not borne or experienced by any individual buyer, even educated buyers may be harmed by the failure of the market to provide optimal quality where the benefits of -optimal quality cannot be sufficiently garnered by the supplier. Bundling can reduce these informational and other free rider problems. When the same vendor sells the bundle of complementary products—"the system"—the vendor can set the quality of the complementary goods at the level necessary to make the system work, and can capture (through increased sales or profits) all the benefits of educating purchasers about the requirements for proper system operation.⁹

27. Likewise, bundling may also facilitate efficient spending on joint marketing and sales of the complementary components of the bundle. The reason is akin to the "free rider" problem discussed above: suppliers of complementary or competing products can benefit from one supplier's advertising without sharing in its cost. Because the supplier that advertises cannot capture the full benefits of the advertising, the result is likely to be under-provision of

⁹ The same phenomenon is believed to be responsible for the decline of code-sharing arrangements between major airlines and separately owned commuter lines. Operating under separate ownership, commuter carriers apparently lacked sufficient incentives to offer high quality service to the passengers interchanged between the commuter lines and the major carriers. The major carriers have moved to replace code sharing with equity ownership (100 percent or partial) of commuter lines. See Michael E. Levine, "Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy," 4 *Yale J. on Reg.* 393, 439-40 (1987). Some observers attribute the growth of equity investments into commuter airlines to the need to capitalize them better and ensure procompetitive benefits of superior service.

informational advertising.¹⁰ However, when a vendor sells a package of complementary products in a bundle, it has proper incentives to market and otherwise promote the whole bundle of complements. Several carriers have noted the marketing-related benefits of bundling. *See, e.g., MCI WorldCom* at 9 (existing “rule still prevents IXCs from passing along the cost savings resulting from joint marketing and sales of services and CPE”).

28. In all of these regards, it is clear that bundling of interexchange service with CPE or enhanced services would allow interexchange carriers, which the FCC has recognized as nondominant, to achieve better integration of design, manufacture, marketing, promotion, reputation building, and information provision, without engendering competitive concerns arising from bundling by a regulated dominant telecommunications services vendors.

B. Improved Recovery Of Fixed And Sunk Costs Under Competitive Conditions

29. We now turn to the second key potential benefit from bundling. Bundling can also facilitate efficient recovery of joint and common costs and stimulate usage (sales) of desirable services to a wider range of potential customers. In particular, bundling allows better recovery of the R&D costs of innovative technology, while enabling buyers who are unable or unwilling to pay the stand-alone prices to obtain the new product as part of a bundle.¹¹ These benefits are

¹⁰ In some circumstances, joint marketing agreements among all the suppliers can provide an alternative mechanism for internalizing the benefits of advertising by requiring all of its beneficiaries to share in its costs. However, negotiating and administering joint marketing agreements may be infeasible or uneconomic.

¹¹ *See* Michael Levine, “Price Discrimination Without Market Power,” Harvard Law School Discussion Paper No. 276 (Feb. 2000).

especially likely to arise in effectively competitive markets where rivalry constrains the ability of firms to charge monopoly prices for bundles or components.

30. The salient aspect of R&D investment is its sunk and fixed character. R&D expenses, once spent, cannot be avoided even if the new product or service never reaches the market. Moreover, expenditures on R&D are a classic example of a fixed cost: virtually the entire cost must be incurred to produce the first unit of the product while producing the next units requires little or no additional R&D expense. (Software and video recordings exemplify the phenomenon of high fixed costs and very low marginal costs.)

31. When fixed costs are a significant portion of total costs, marginal cost pricing likely will not recover R&D and other fixed costs.¹² To recover these costs, the innovator must set prices above marginal production cost for at least some customers. Without the opportunity to recover R&D and other fixed costs, suppliers will not invest enough in R&D. Economists have demonstrated that the most efficient way to recover these fixed costs from purchasers in the market, while minimizing the inefficiency that results from pricing above marginal cost, is to charge higher markups to customers with relatively inelastic demand, and lower markups to customers with relatively elastic demand.

32. For many goods, however, suppliers have no way of determining precisely (if at all) the demand elasticities of potential customers. By offering different bundles, the seller can

¹² In general, marginal cost pricing does not yield revenues sufficient to recover total economic cost when there are increasing returns to scale in the relevant range of output.

rely on customer self-selection to facilitate efficient recovery of fixed costs without detailed knowledge of individual consumers' demand elasticities.

33. Consider, for example, restaurant pricing. Restaurants commonly offer many menu items both individually at separate prices and combined into one or more fixed price meals. McDonald's and other fast food restaurants offer burgers, fries and shakes both individually and combined as "value meals." Other types of restaurants also offer menu items both à la carte and as part of fixed price combinations. The bundled prices are normally below the sum of the corresponding unbundled prices.

34. The virtue of these arrangements is that they induce diners to sort themselves by the strength of their demands for individual menu items. For example, diners who crave a Big Mac, but are relatively uninterested in fries or a soft drink, can buy the Big Mac alone at a price that makes a higher percentage contribution to MacDonald's common costs than does the *pro rata* price of a Big Mac in a Value Meal, but at a lower absolute price to the customer. The same holds true for aficionados of fries or soft drinks who buy those items alone. Yet customers who attach a relatively uniform value to each component of a Value Meal can buy it for less than the sum of the à la carte prices of each component.¹³ The effect of this mixed bundling strategy is to enable the restaurant to offer customers attractive prices to purchase both complete meals and individually desired items, while earning sufficient contribution to fixed and common costs to support the quality and selection that customers desire.

¹³ For a mathematical demonstration of this point, see William J. Adams and Janet L. Yellen, "Commodity Bundling and the Burden of Monopoly," 90 *Quarterly J. of Econ.* 475 (Aug. 1976), or Louis Phlips, *The Economics of Price Discrimination* 176-86 (1983).

35. The same principle applies to the provision of telephone services. By simultaneously offering basic services, enhanced services and CPE alone and in bundled combinations as the marketplace dictates, a nondominant carrier can effect the scope of sales and financially support the offering of the quality and selection of innovative products and services—including state-of-the-art CPE and enhanced services—that customers demand and that competitive success requires.

36. A simple example should make this point clear. Consider a competitive interexchange carrier that invents a new messaging service, having substantial R&D and fixed implementation costs. Assume also that the marginal cost of providing the service to an additional customer is low (relative to the fixed costs incurred by the innovator). To recover these fixed costs, the interexchange carrier must charge an average price for the service that greatly exceeds marginal cost. At this price, there is substantial demand from those telecommunications customers who also have high willingness to pay for long-distance services generally. However, long distance customers with low willingness to pay for long-distance service also have a rather low willingness to pay for the innovative new voice messaging service.

37. The seller faces a marketing dilemma. One strategy could be to charge a very high price to cover costs. At that price, however, many customers would not take the service even though they would be willing to pay a price closer to marginal cost. Another strategy could be to charge a low price, near marginal cost. That strategy would induce (almost) all potential customers to take the service. The problem is that such a strategy would not recover total fixed costs, including the original expenditure on R&D.

38. Bundling offers a solution to the marketing problem. The carrier offers the messaging service on a stand-alone basis at a price substantially above marginal cost. It also bundles the messaging service with its standard long-distance calling plans. The carrier “marks-up” those usage plans that appeal to those with a high willingness to pay for interexchange service, and adds the new service to them. The carrier also bundles the messaging service with usage plans that appeal to those with a low willingness to pay for interexchange service, but at a much lower mark-up.¹⁴ Offering both sets of bundles attracts customers from both high-willingness-to-pay and low-willingness-to-pay groups, and thus fosters efficient dissemination of the service. Furthermore, the revenues collected by the interexchange carrier increase, because the revenues secured for the new service from the high willingness-to-pay group are not undermined,¹⁵ while modest additional revenues are secured from the low-willingness-to-pay group.

39. Competition facing the interexchange carrier further enhances the consumer benefits from this bundling strategy. The competition impels the interexchange carrier to offer the bundle; otherwise the low-willingness-to-pay consumers will be drawn to the competitor who offers his own version of the messaging service bundled with his usage plan for this group. And

¹⁴ Concretely, assume that the high usage plan has a fixed fee of \$10 per month and a usage rate of \$0.05 per minute; and the low usage plan has a usage-only rate of \$0.10 per minute, with no monthly fee. Then the carrier may offer the new service to both customer groups by marking up the former plan to \$12 in a fixed fee and unlimited voice messaging and the latter plan to \$0.105 per minute up to 100 messages per month. Confronted with these options, both groups of customers will stick with their plans *and* receive the new service.

¹⁵ As they would, if the vendor tried to attract all customers with low prices.

the competition tends to discipline the prices set for the messaging service both alone and bundled with other interexchange services down toward the necessary economic cost. Here, the added opportunities afforded by bundling do not raise net profit greatly, but they do mean that the interexchange carrier will avail itself of the opportunities and use the added net revenue potential to lower other prices—not because of regulation or altruism, but because of the threat that customers will otherwise divert their business to other interexchange carriers that offer better deals and more attractive bundles of services. Thus, the ability to bundle leads to good outcomes for social welfare and consumers, especially where there is effective competition.

40. The above examples are more than merely hypothetical. We understand from AT&T's business managers that the company, if allowed to do so, would offer a number of bundles of basic services with CPE and/or enhanced services. AT&T, for example, would seek to bundle 800 *en route* announcements with media announcements; bundle DSL service with enhanced service; bundle DSL service with CPE and enhanced service; bundle DSL service with CPE; and bundle basic voice and data services with Integrated Network Connection Service, an enhanced service for business customers that provides more effective use of bandwidth through ATM statistical multiplexing, voice compression and protocol conversion.¹⁶

¹⁶ Integrated Network Connection Service includes both enhanced services and CPE. The service configuration consists of network equipment, CPE, T1 access facilities, and network management services. The integrated service supports up to 24 voice calls and over 1.2 Mbps of Frame Relay or IP traffic on one T1 access facility. Bandwidth is dynamically allocated by an AT&T-provided ATM multiplexer located on the customer's premises that automatically assigns bandwidth as needed to the type of supported traffic (voice, frame relay and IP). We understand that AT&T believes that Integrated Network Connection Service lowers the customers' network management requirements, and provides the customer a cost-effective means of migrating to packet voice service. From the customer's perspective, the service is part of a seamless voice

41. Bundles of this kind offer great potential benefits to consumers. As one customer group summarized in its November 1998 comments, “[f]rom the perspective of corporate users, elimination of the bundling restrictions is one of the preeminent deregulatory initiatives the Commission could undertake.” API at 3; *see also* ENTUA at 3.

42. Whether to allow bundling by a particular telecommunications carrier, however, must also depend on whether the firm offering the bundle has market power over any component of the bundle, and whether regulation exacerbates incentives to bundle anticompetitively. If monopoly power is absent, bundling should be allowed. If the firm has monopoly power over any component of the bundle, competitive risks may arise. In the present context, relieving incumbent LECs of the existing bundling restrictions would create competitive risks that likely would outweigh the potential benefits—at least until markets for local exchange and access become workably competitive. We elaborate on these conclusions in the following two sections.

IV. BUNDLING OF BASIC TELEPHONE SERVICES WITH ENHANCED SERVICES AND CPE BY NONDOMINANT INTEREXCHANGE CARRIERS DOES NOT POSE COMPETITIVE RISKS.

43. Interexchange carriers do not have market power over any services and goods sold by them. Consequently, if these carriers were to be allowed to bundle these services, they would not gain market power over bundles themselves. Hence, bundling by these carriers poses

and data network solution. Because the service includes both enhanced service and CPE, however, AT&T is not permitted now to offer its components to customers in a single bundle with basic voice and data service.

no significant competitive risks to offset the potential benefits, and so it is clear that elimination of the current bundling restrictions as applied to these carriers is long overdue.

44. Existing bundling restrictions are onerous. The current rules preclude telecommunications carriers from bundling CPE or enhanced services with basic services. CPE must be offered at a non-tariffed separate price from basic services. Any basic service offered in a package with an enhanced service must also be offered at a separate, unbundled price. With few exceptions (e.g., a promotional subsidy of CPE by an unaffiliated vendor), neither CPE nor enhanced services may be offered in a bundle at a package price below the sum of the unbundled prices of the individual components of the package.

45. As the FCC acknowledges (FNPRM at 2), the bundling restrictions at issue here were adopted in 1980, when the structure of the telephone industry was vastly different. Two decades ago, markets for CPE and for enhanced services were in their infancy. The FCC was understandably concerned that interexchange carriers with market power could use bundling to “restrict customer choice and retard the development of competitive CPE and enhanced services markets.”

46. These markets have undergone enormous changes in the intervening twenty years. Even in *Computer II* itself, the FCC found that there should be no anticompetitive effects from selling two services together in a bundle “[i]f the markets for both components of the commodity bundle are workably competitive.” The FCC has properly adopted this analysis as the test for removal of the bundling restrictions in the FNPRM, and tentatively concludes that where both

markets are competitive it is “unlikely that nondominant interexchange carriers could engage in the type of anticompetitive conduct that led the FCC to prohibit” bundling of interexchange services with either CPE and/or enhanced services. See FNPRM at 12; AT&T Comments (Nov. 23, 1998) at pp. 4-8; AT&T Reply Comments (Dec. 23, 1998) at pp. 2-6.

47. Today the markets for interexchange services, CPE, and enhanced services markets are vigorously competitive, as the Commission and nearly all commenting parties have recognized. See FNPRM, at pp. 13, 36 (seeking comment); AT&T Comments (Nov. 23, 1998) at pp. 4-8; AT&T Reply Comments (Dec. 23, 1998) at pp. 2-6.

48. First, as the FCC has properly found many times, the interexchange market is highly competitive. Over 600 carriers provide long distance services; at least 20 of these carriers had annual revenues exceeding \$100 million in 1997, and eight carriers had annual revenues exceeding \$1 billion.¹⁷ As a group, “carriers other than the four largest long distance carriers have demonstrated annual growth rates exceeding 40 percent.” In 1995, the FCC, finding that AT&T lacked unilateral market power in the long distance market, reclassified AT&T as a nondominant carrier. In 1998, the FCC found that the market trends that supported its conclusion that AT&T lacked market power in long distance services “continue today.” *MCI WorldCom Merger Order*, at 41. For example, “residential and business customers are highly price sensitive and will switch long distance carriers to obtain price reductions and desired

¹⁷ *Application of WorldCom, Inc. and MCI Communications Corp. v. Transfer of Control of MCI Communications Corp. of WorldCom, Inc.*, CC Docket No. 97-211, Memorandum Opinion and Order, ¶ 40 (rel. Sept. 14, 1998).

features.” *Id.* Moreover, competitors in the long distance market have enough readily available capacity to constrain each other’s pricing behavior. *Id.* Indeed, as the FCC has noted, four interexchange carriers are building new nationwide facilities-based fiber-optic networks, which will only increase competitive pressures in the interexchange market. *Id.* at 43-63; *see also id.* at 64 (noting that existing facilities-based carriers are using new technologies to increase capacity on their networks).

49. The FCC’s findings are supported by the consensus of the comments filed by parties in this proceeding in late 1998. For example, many commenters acknowledged that “competition in the domestic interexchange market has evolved to the point where no carrier is able to exercise market power in the provision of long distance services.” *See, e.g.,* Sprint at 3; ISP/C at 6; CompTel at 3,5; MCI WorldCom at 7; API at 8-9. With the interexchange market competitive, bundling poses no threat to competition, because, as Sprint stated (at 4), “[a] carrier without market power can no more force a customer into purchasing unwanted products or services than Giant can force customers to shop at its stores rather than Safeway.”¹⁸

50. The FCC has also properly recognized that the market for CPE is vigorously competitive. In *Computer II*, the FCC concluded that the CPE market faced “an increasing amount of competition as new and innovative types of CPE are constantly introduced into the

¹⁸ *See also* MCI WorldCom at 7 (“[w]hatever pricing advantage an IXC could offer by selling service and CPE at a bundled discounted price would have to be cost-related -- and therefore not harmful to competition -- or the IXC could not profitably offer such a bundled discount in the long run”), 30-31 (only leverage IXC could bring to bear would be whatever leverage could be derived from the superior value and quality of its services, considered separately).

marketplace.” *Computer II* Final Decision, 77 F.C.C.2d at 439 (¶ 141). Competition in the CPE market has only intensified since then. Virtually all commenters in this proceeding have agreed that the market for CPE is intensely competitive. *See, e.g.,* BellSouth at 3-4; API at 8-9; Ameritech at 7; Bell Atlantic at 7-10; CompTel at 3.

51. Likewise, there can be no serious dispute that the market for enhanced services is vigorously competitive. As early as 1980, the FCC found that competition for enhanced services was so strong as to obviate any need for regulation under Title II. *Computer II Final Decision*, 77 F.C.C.2d at 430, 432-33; 47 C.F.R. § 64.702(a). The FCC has reaffirmed that finding numerous times. In its 1998 Report to Congress on Universal Service, the FCC observed that under the *Computer II* framework “enhanced services [have seen] exponential growth.” As the FCC noted, Internet usage has grown rapidly, and there are now more than 4000 Internet service providers and 40 Internet backbones operating in the United States. *Report to Congress*, ¶ 65. Internet service provider revenues are projected to grow from four billion dollars in 1996 to eighteen billion dollars in 2000. *Id.* Other enhanced services have also matured into highly competitive markets. Nearly all the commenting parties in this proceeding have agreed that the market for enhanced services is intensely competitive. *See, e.g.,* BellSouth at 3-4; API at 8-9; Ameritech at 7; Bell Atlantic at 7-10; CompTel at 3; [add cites to reply comments].

52. The structural competitiveness of the markets for interexchange service, enhanced services and CPE provides ample basis for concluding that allowing nondominant interexchange carriers to bundle these services will not harm competition. First, widespread bundling in competitive markets is strong evidence that bundling of competitive services benefits

competition and consumers. When competitive alternatives are available for each component of a bundle, no vendor can force purchasers to buy the bundle rather than the unbundled components, or to buy a bundle that the customer does not want. That bundles are offered and sold in this circumstance demonstrates that such bundled offerings are more attractive than the available unbundled alternatives. Moreover, when there is strong competition among independent sellers of bundled and unbundled offerings, consumers cannot be forced to purchase products that they do not want and in combinations that are less than desirable. To be sure, the extent and scope of bundling depend on a myriad of factors, including the heterogeneity of consumers' preferences for different components of potential bundles, the cost functions of existing and potential supplier, and the extent of the transaction costs incurred in buying, selling and using the goods. Still, there is no reason to believe that regulatory (or antitrust) restrictions on bundling can improve upon the performance of unfettered competitive markets.

53. Perhaps the greatest costs from regulatory intervention in markets stem from the inevitably imperfect information available to the regulator. No centralized regulator—no matter how intelligent, conscientious and well informed—can approach the responsiveness and suppleness of the feedback loop known as the free competitive market. Nor can any regulator approach the market's effectiveness in matching the wants and needs of consumers with the technology and resources available to producers, now and in the future.

54. The rules against bundling by nondominant interexchange carriers exemplify these problems. The relevant technologies – digital communications, the Internet, computers – are complex and rapidly evolving. These technologies, and the services that they support, are

rapidly converging with telephony, data transmission, interactive online services, and video, which increasingly are available over diverse transmission media. *See* Notice of Inquiry, *Inquiry Concerning the Deployment of Advanced Communications Capability to All Americans in a Reasonable and Timely Fashion*, 13 FCC Rcd. 15280, ¶ 2 (1998) (“Section 706 Notice of Inquiry”). No one can predict where all of this change will ultimately lead. It is clear, however, that this revolution in the development and dissemination of information technologies has been facilitated by a consistent “hands off” regulatory philosophy. In these circumstances, maintaining regulatory constraints on the ability of competitive firms to offer consumers bundles comprising a wide variety of telecommunications services and CPE is likely to produce a net deadweight loss to consumers.

55. Some parties commenting in this docket have argued that interexchange carriers, “even if lacking market power, nevertheless might have the ability to force consumers of their interstate, interexchange service offerings to purchase CPE from that same interexchange carrier.” *See* FNPRM at ¶ 13. For the reasons explained above, this concern is unwarranted. If a nondominant interexchange carrier attempted to “force” a customer to buy CPE from it, the consumer would have plentiful options in the interexchange market and could simply switch to another interexchange carrier. *See, e.g., AT&T Nondominance Order*, 11 FCC Rcd. at 3305-06 (¶¶ 63-65) (residential and business customers are highly price sensitive and will switch long distance carriers to obtain price reductions and desired features). A supplier in a competitive market cannot force undesirable bundles of services and equipment on purchasers who can turn to other bundles or to stand-alone offerings. A supplier that failed to provide what consumers

want would simply lose its customers to competing suppliers that offer better bundles or unbundled components on more attractive terms.

56. There is no need to impose on interexchange carriers the “unbundled option” requirement—*i.e.*, a requirement that carriers who offer bundled packages also offer the constituent services and products on an unbundled basis – as a precondition for allowing them to offer services and CPE on bundled basis. *See* FNPRM at 21. In a competitive market, the best evidence of the competitiveness of any offering is whether customers want to purchase it or not. When purchasers prefer to buy services individually rather than in bundles, a supplier in a competitive market that persists with a pure bundling strategy will lose its customers to competing suppliers willing to offer the individual products. *See* MCI WorldCom Comments (Nov. 23, 1998) at 36-39; CompTel Comments (Nov. 23, 1998) at 7.¹⁹

57. Similarly, interexchange carriers will have every incentive to make efficient make-or-buy decisions after being allowed to bundle basic services with CPE and/or enhanced services. Because each of these markets is vigorously competitive, discrimination against efficient suppliers of CPE or enhanced services would merely squander the interexchange carrier’s potential profits. A carrier that included inferior or overpriced products or services in a bundle would needlessly sacrifice potential sales or profit margins.

¹⁹ As the FCC has recognized, both residential and business interexchange customers are highly price sensitive and will switch long distance carriers to obtain price reductions and desired features. *E.g.*, *AT&T Nondominance Order*, 11 FCC Rcd. at 3305-06 (¶¶ 63-65).

V. ALLOWING INCUMBENT LECs TO BUNDLE BASIC SERVICES WITH ENHANCED SERVICES WOULD POSE AN UNACCEPTABLE RISK TO COMPETITION.

58. In contrast to the appropriate policy towards the competitive interexchange carriers, there is a continued public policy need to scrutinize carefully the bundling strategies of regulated vendors who have monopoly power over essential services or facilities that are needed by their rivals.²⁰ Incumbent LECs are plainly still in this category. Although competitive local exchange carriers ("CLECs") have made some inroads, particularly among business customers in major cities, incumbent LECs continue to have monopoly power in the provision of local exchange services, including access, and remain the sole actual providers of local exchange and exchange access services to the vast majority of residential and small business customers in most areas of the United States. In most service areas, incumbent LEC market shares for local exchange and local access are still above 95 percent. There is no sign of any significant ebbing of their dominance over the mass market for local exchange services and local access.²¹ As long as this monopoly power in the hands of the regulated LECs remains, relieving them of the existing bundling restrictions would pose an unacceptable risk of competitive injury.

59. A dominant regulated local exchange carrier has both the motive and the means to leverage its monopoly power into product markets' for enhanced services by bundling basic local

²⁰ See FNPRM, ¶¶ 27-30, 40; see also Ex Parte Declaration of Janusz O. Ordovery and Robert D. Willig filed Sept. 17, 1999, *In the Matter of Applications for Consent to the Transfer of Control of Licenses MediaOne Group, Inc., Transferor, To AT&T Corp., Transferee*, CS Docket No. 99-251, ¶¶ 25-26, 69, 77-80.

²¹ FCC Common Carrier Bureau, *Local Competition* (Aug. 1999) at 1 and Table 2.1.

exchange service or access with enhanced services. The motive exists because federal and state regulations are designed to prevent such a carrier from fully exploiting its pricing power over its monopoly bottleneck local services. Bundling enables the carrier to exercise this unexploited pricing power in otherwise-competitive markets for complementary goods or services.

60. For example, a dominant local carrier might harm competition for a non-monopoly enhanced service by implicitly pricing it at a non-compensatory level.²² This strategy entails setting the unbundled price of the basic service and the price of the combined bundle of services close enough to each other so that the differential is less than the incremental cost of supplying the non-monopoly enhanced service alone. In this scenario, the direct effect of the conduct is to squeeze out the competing suppliers of the enhanced service that might otherwise serve as attractive complements to the basic services offered by the incumbent LEC. Elimination of the competing suppliers of the enhanced service in turn reduces the attractiveness of the service bundles and packages offered by potentially competing LECs, because the latter firms have no alternative source of the attractive complementary enhanced service that the incumbent LEC can offer. Bundling adds to the pressure on the potentially competing LECs because it leaves the incumbent LEC as the dominant supplier to consumers of more of the goods and services in the bundle. By gaining control over the product market for the complementary enhanced service, bundling could help the incumbent LEC to maintain or enhance its market power over its basic monopoly services.

²² Analogous examples might entail bundling some types of CPE with local exchange services.

61. Allowing incumbent LECs to bundle basic services with enhanced services could also better enable them to squeeze out efficient potential competitors through non-price means—e.g., by offering lower quality monopoly bottleneck services to customers of their competitors, and by providing quicker or more complete disclosure of their network interface specifications and protocols to favored vendors. The point here is that bundling potentially “covers up” discrimination since the bundling incumbent LEC can claim that the lower price of the package allegedly stems from efficiencies made possible by close integration of the package. The comments filed in November 1998 provide evidence that such concerns are more than theoretical. Indeed, the incumbent LECs may already be engaged in bundling of some enhanced services with basic local services, demonstrating the opportunities for leverage that could be dangerous to competition.

62. For example, the Commercial Internet Exchange Association (“CIX”) has submitted copies of advertisements in which incumbent LECs are *already* offering package discounts for local service bundled with Internet access services and CPE (such as modems). *See* CIX Comments at 8-9. Other commenters offer similar evidence. *See, e.g.*, America Online Comments at 8 & n.16, 10 (incumbent LECs have offered free Internet access with the purchase of a second line, and noting other concerns about anticompetitive conduct and discrimination); Team Centrex Comments at 3-4 (subsidization of Centrex CPE with Centrex revenues); Network Plus Comments at 5-6 (Bell Atlantic tying of local services and voice messaging services harming local competition); ISP/C Comments at 7 (“[m]any ISPs can provide detailed accounts

of RBOC and GTE behavior that an impartial observer would have to describe as intentional discrimination”).

63. As these examples suggest, allowing dominant LECs to include local service in bundles with enhanced services could greatly increase the potential for anticompetitive behavior. Accordingly, existing restrictions on the incumbent LECs’ ability to bundle basic services with enhanced services should remain in effect.

64. An incumbent LEC should not be allowed to engage in bundling merely by showing that its Section 271 application has been approved. For example, Bell Atlantic’s performance after its Section 271 application was approved in New York State belies the assumption that the right of competing LECs to purchase the UNE platform from incumbent LECs creates competitive conditions in the provision of local exchanges services sufficient to neutralize the competitive risks from their bundling. This experience confirms that regulatory approval of Bell Atlantic’s Section 271 application did not ensure that Bell Atlantic’s operation support systems would work as required to ensure that competition would be effective.²³ Until the FCC and the public have gained practical experience with implementation of Sections 271 and 272, and the practical experience demonstrates that these mechanisms are reliable safeguards against competitive abuses, it is premature to conclude that availability of the UNE platform is sufficient to protect against competitive injury from bundling of local service(s) with other

²³ See Declaration of Stephen G. Huels and Denise E. Smith on behalf of AT&T Corp. (February 2000) (attached as Exhibit C).

service(s) or product(s). Bundling restrictions should be lifted from incumbent LECs only after the markets for local services become effectively competitive.

65. Likewise, the FCC should continue to exercise controls over bundling conduct by the nominally “nondominant” interexchange carriers that are affiliated with the incumbent LECs, until such time that it becomes clear that the incumbent LECs face effective competition, or that the separate subsidiary rules are effective in separating the incentives and decision-making of the affiliated interexchange carriers from the incentives and decision-making of the incumbent LECs that own them. If neither of these conditions hold, the same types of competitive risks that attend bundling by the incumbent LECs themselves also surround bundling by their interexchange affiliates of services or products that can be advantaged relative to competing alternatives through their relationship to the incumbent LEC’s monopoly bottleneck services. Such services and products likely include most if not all enhanced services.

66. Further, the FCC should reject appeals to “regulatory parity” offered by several incumbent LECs as a justification for allowing them to offer bundles of goods and services as freely as nondominant interexchange carriers.²⁴ Although “regulatory parity” is a sound public policy, appeals to regulatory parity in this case completely ignore the structural difference between bundling by firms facing effective competition in the relevant markets and by regulated firms with monopoly power over bottlenecks. As explained above, bundling can serve as a mechanism for anticompetitive conduct only when the firm lacks robust effective competition for

²⁴ See BellSouth at 11-13; GTE at 15-18; USTA at 3.

one or more of its services; otherwise, bundling poses no risks while potentially bringing significant benefits to consumers.

67. For this reason, there is nothing unfair, anticompetitive or illogical about allowing nondominant carriers to bundle their services with CPE or enhanced services, while retaining the bundling restrictions for the dominant LECs as described above. The dominant LECs' regulated monopoly power gives them the marked ability and incentive to harm competition through bundling, and the FCC's rules should therefore treat the dominant and non-dominant LECs differently. The FCC's longstanding distinction between dominant and non-dominant carriers has promoted, not frustrated, the development of competition despite the fact that it treats carriers differently. *See, e.g.*, MCI WorldCom Comments (Nov. 23, 1998) at 26. The FCC should adhere to those distinctions in this context, and should not permit the dominant LECs to bundle local services with enhanced services.

68. Finally, the incumbent LECs' recent conduct belies any notion that existing restrictions on bundling are preventing the incumbent LECs from deploying advanced services' capabilities. For example, in the domain of DSL, the incumbent LECs have nearly 500,000 DSL customers, and are adding more than 100,000 additional ones per month. More than 40 million homes were DSL capable by year-end 1999. SBC alone plans to offer DSL to 77 million homes by 2002.

VI. THE COMMISSION SHOULD CONTINUE TO REQUIRE INCUMBENT LECs TO PUBLISH NETWORK INTERFACE INFORMATION.

69. The regulatory requirements for publication of network interface information involve much the same sort of competitive issues as those covered in our discussion of bundling. Compliance with these requirements is costly. Carriers must maintain large staffs of employees devoted to compiling and publishing the required disclosure statements, in the precise form demanded by the rules.

70. For interexchange carriers, which are no longer dominant, these costs are needless and unwarranted. Consumers are protected by robust competition. Consequently, there should be no active and costly regulation of disclosure practices by the competitive interexchange carriers.

71. Disclosure strategies for interface information of this kind vary widely in unregulated competitive markets. In many circumstances, the market participants have concluded that full and immediate disclosure of their interface specifications and requirements is necessary to encourage sufficient innovation in the development of complementary goods and services by other firms. In other circumstances, firms have found that limiting the disclosure of interface specifications and requirements, at least temporarily, is necessary to secure an adequate return on investment in innovation. In competitive markets, however, there is no need for any regulator to second-guess the reasonableness of this conduct. A firm that fails to disclose an appropriate amount of information at an appropriate time, or that insufficiently guards its intellectual capital will be competitively disadvantaged vis-à-vis its rivals. And if and when

firms facing effective competition err in these decisions, they are the first to suffer, while consumers are protected by options to deal with alternative suppliers who have made decisions that make their own offerings more attractive.

72. In contrast with competitive interexchange carriers, regulated dominant local carriers have strong incentives to withhold quick and complete publication of network interface information, even where such disclosure is necessary to bring maximal benefits to consumers. By withholding or delaying the disclosure of such information to competing suppliers of specialized CPE or enhanced services, a dominant carrier might enable its preferred partners anticompetitively to earn supranormal profits. The dominant carrier could appropriate a share of these monopoly rents to itself through transfer prices or licensing arrangements with its partners. Strategies like these enable the dominant carrier to circumvent regulatory constraints on exploitation of its pricing power, and have the effect of squeezing out efficient competing suppliers of CPE and enhanced services. Accordingly, existing requirements for publication of network interface information should remain in force for dominant local exchange carriers. The costs of releasing the incumbent LECs from these requirements are likely to exceed the benefits to consumers by a wide margin.

VII. CONCLUSION

73. Whether a telecommunications services vendor should be allowed to bundle basic services with enhanced services or CPE should depend primarily on the competitiveness of the market for the basic services and on the market power of the vendor. Because the market for

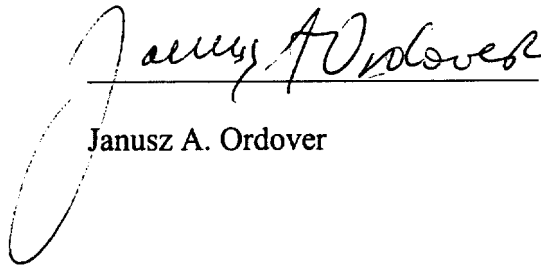
basic interexchange services is effectively competitive, there is no competitive risk from permitting bundling of these basic services with CPE or enhanced services to offset the competitive benefits of such bundling. On the other hand, because the market for basic local exchange and access services has yet to become effectively competitive, bundling of these basic services by regulated incumbent LECs with enhanced services would pose unacceptable competitive risks.

74. Bundling of effectively competitive products and services by competitive suppliers provides a variety of competitive benefits, as described at length in Section III, above. In competitive markets, there are unlikely to be any competitive harms to offset these cognizable benefits of bundling. Hence, subjecting nondominant interexchange carriers to restrictions on bundling of basic services with CPE or enhanced services is a costly anachronism that unambiguously reduces consumer welfare.

75. The same is not true of bundling by incumbent LECs. Bundling can enable such regulated firms profitably to leverage monopoly power into adjacent markets—by using the monopoly service or services to squeeze out competing suppliers of complements, or by giving favored suppliers of the bundled services preferential access to the technical specifications or interfaces of the dominant firm's network. For the local telephone industry, these risks are great enough to warrant maintaining existing restrictions on bundling basic services with enhanced services until these dominant carriers lose their monopoly power over local exchange services and local access. As long as the incumbent LECs retain their substantial regulated monopoly power over local services, they can exploit bundling to injure competition.

VERIFICATION

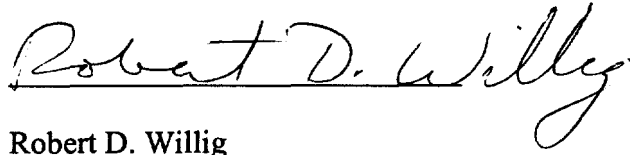
I, Janusz A. Ordoover, declare under penalty of perjury that the foregoing is true and correct. Executed on May 1, 2000.


Janusz A. Ordoover

VERIFICATION

I, Robert D. Willig, declare under penalty of perjury that the foregoing is true and correct.

Executed on May 5, 2000.

A handwritten signature in cursive script, reading "Robert D. Willig", written over a horizontal line.

Robert D. Willig